

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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subject: Request for Taxpayer-Specific CCA Regarding Returned/Defective Merchandise Vendor Allowances

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

ISSUES

1. Whether the returned/defective merchandise vendor allowances described below should be treated as part of total sales under § 1.61-3(a) of the Income Tax Regulations or as a discount that reduces the cost of inventory under § 1.471-3(b).
2. If the returned/defective merchandise vendor allowances are treated as a discount that reduces the cost of inventory, should the allowances reduce the cost of all merchandise purchased from the vendor, or alternatively, only the cost of merchandise subsequently determined to be defective?
3. Whether the defective merchandise qualifies as subnormal goods under § 1.471-2(c) or whether the cost of defective merchandise is rework labor, scrap or spoilage capitalizable to the non-defective merchandise as an indirect cost pursuant to § 1.263A-1(e)(3)(ii)(Q).

CONCLUSIONS

1. The returned/defective merchandise vendor allowances described below are not part of total sales under § 1.61-3(a) and instead should be treated as a discount that reduces the cost of inventory under § 1.471-3(b).
2. The returned/defective merchandise vendor allowances should reduce the cost of all merchandise purchased from the vendor, rather than just the merchandise found to be defective.
3. The defective merchandise qualifies as subnormal goods under § 1.471-2(c).

FACTS

Taxpayer is engaged in the business of selling merchandise. Taxpayer acquires merchandise from a number of vendors that are unrelated to Taxpayer. Some of the merchandise received from vendors is determined to be defective. Taxpayer may discover that an item is defective when it is unloaded off the truck in Taxpayer's distribution centers, when the item is unpacked from its container in either the distribution center or in the store, or when the item is returned to Taxpayer by a customer. Once Taxpayer determines items are defective, the items are either discarded, sold at reduced prices, or returned to the vendor.

Many vendors permit or require Taxpayer to return defective merchandise for a refund. Pursuant to agreements with certain vendors, however, Taxpayer receives "returned/defective merchandise vendor allowances" when it purchases merchandise. This allowance is stated as a fixed percentage of total purchases, and is intended to cover the estimated costs of defective merchandise sold to Taxpayer. Taxpayer is generally not required to actually return the defective merchandise or otherwise notify the vendor of the amount of merchandise determined to be defective.

The agreement at issue provides in pertinent part:

SUPPLIER OPTION #3: MEMBER SATISFACTION MERCHANDISE ALLOWANCE. NO VENDOR CLAIM WILL BE FILED.

Supplier is providing a Member Satisfaction Merchandise Allowance as stated in this Agreement. The percentage provided must be adequate to cover all returned merchandise, including but not limited to defective/returned merchandise, or additional claims will be filed by Company, in its sole discretion at our fiscal year end. Returned merchandise must be disposed of by the [store]... [t]hrough salvage, liquidation or recycling operations, with no obligation to account for the proceeds of such disposal.

From time to time, Taxpayer and/or the vendor will conduct a study to determine if the returned/defective merchandise allowances are still representative of the actual defective rate. If a change is necessary, the vendor allowances on future purchases are

adjusted. Under some circumstances, the vendor may agree to retroactively adjust the amount of the vendor allowance. The agreement does not require repayment or retroactive reduction of the vendor allowance if the defective rate is less than the estimated rate.

Taxpayer uses the retail inventory method for some of its locations. For other locations, the invoice cost method is utilized. Some of the merchandise for which the returned/defective merchandise allowances are received is valued under the LIFO method, while other merchandise is valued under the FIFO method. Taxpayer uses the simplified resale method to capitalize additional § 263A costs.

LAW AND ANALYSIS

Issues 1 & 2

Section 61(a)(3) of the Internal Revenue Code defines gross income generally as all income from whatever source derived, including gains from dealings in property.

Section 1.61-3(a) provides that in a manufacturing, merchandising, or mining business, gross income means the total sales, less the cost of goods sold, plus any income for investments and from incidental or outside operations or sources.

Section 471(a) provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

Section 1.471-3(b) provides that cost means, in the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed.

At issue is whether the returned/defective merchandise vendor allowances should be included in Taxpayer's sales revenue, or whether such allowances should be treated as a discount. If the allowances are properly treated as a discount, at issue is whether the allowances should reduce the cost of all merchandise purchased from the vendor, or only the cost of merchandise subsequently determined to be defective.

Trade discounts represent adjustments to the purchase price granted by a vendor. The discount may vary depending upon volume or quantity purchases, or other factors established by the vendor. If a discount is always allowed irrespective of time of payment, it is considered to be a trade discount regardless of the purported conditions which must be met in order for the discount to apply. See Thomas Shoe Co., 1 B.T.A. 124 (1924). Cash discounts, on the other hand, represent a reduction in the invoice or

purchase price attributable to payment within a prescribed time period; the discount is only available if the purchaser makes payment within such time period.

In Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), the Tax Court addressed whether allowances made by a milk producer to certain purchasers of its milk were adjustments to the sales price of the milk, or ordinary and necessary business expenses under § 162. The allowances were computed by applying a specific percentage to list prices fixed by the Milk Control Commission, resulting in a net cost to the customer which was below the list price, in violation of state law. The court opined that when determining gain from the sale of property, the amount realized must be based on the actual price or consideration for which the property was sold, and not on some greater price for which it possibly should have been, but was not, sold. The Tax Court found that the allowances were part of the sales transaction, and concluded that gross income must be computed with respect to the agreed prices (net of rebate) at which the milk was sold. The court noted the allowances were "...not contingent upon any subsequent performance or consideration from the purchaser.." Accordingly, the Tax Court held that the purpose and the intent of the allowance was to reach an agreed upon net selling price, and the allowance was properly viewed as an adjustment to the sales price.

Returned/defective merchandise vendor allowances are provided in lieu of actual merchandise returns. Although the accounting entries may differ from taxpayer-to-taxpayer, proper accounting for returned merchandise generally has the same effect as if the merchandise were sold for its cost. Treating the returned/defective merchandise allowances as part of total sales in the § 1.61-3 formula in the year of acquisition would produce the same results as the proper accounting for actual merchandise returns if the defective merchandise was discovered and discarded in the taxable year of acquisition and the actual defective rate equaled the estimated defective rate. Thus, an issue arises as to whether returned/defective merchandise vendor allowances should be treated as part of total sales.

Despite the fact the returned/defective merchandise vendor allowances are provided in lieu of actual merchandise returns and despite the fact that the allowances are characterized as compensation for defective goods, the allowances are properly accounted for as reductions to the invoice cost of merchandise under § 1.471-3(b). The returned/defective merchandise allowances at issue are fixed allowances provided regardless of the amount, if any, of defective items in the purchased merchandise. The allowances are not dependent upon proof of actual defects or upon return or disposition of defective merchandise. Accordingly, the allowances are akin to a trade discount. In negotiating the allowance, the vendor and Taxpayer have reached an agreed upon net selling price for all of the merchandise. Thus, the allowances are not part of total sales under § 1.61-3(a), but rather should be treated as discounts that reduce the cost of inventory pursuant to § 1.471-3(b).

Furthermore, because the existence and amount of actual defective items is unknown at the time of the sale and generally irrelevant to the net selling price, the

returned/defective merchandise vendor allowance is properly treated as a reduction to the cost of all merchandise purchased from the vendor, rather than a reduction only to the cost of items subsequently determined to be defective. The allowances are not dependent on the Taxpayer's discovery of defective items in the purchased merchandise, and Taxpayer is not required to return the allowances if the actual amount of defective inventory is less than expected. The allowances therefore are not tied to specific items of defective inventory, but rather relate to all items of purchased merchandise. Accordingly, the discount reduces the cost of all of the merchandise purchased from the vendor.

Issue 3

Section 1.471-2(c) provides that any goods in inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether the taxpayer values its inventory at cost or lower of cost or market. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date.

Section 263A provides that taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to property acquired for resale. See also § 1.263A-1(c)(1).

Section 1.263A-1(e)(3)(i) provides that, in the case of property acquired for resale, indirect costs are all costs other than the acquisition cost of merchandise. Taxpayers subject to § 263A must capitalize all indirect costs properly allocable to property acquired for resale. Indirect costs are properly allocable to property acquired for resale when the costs directly benefit or are incurred by reason of the performance of resale activities.

Section 1.263A-1(e)(3)(ii)(Q) provides that indirect costs required to be capitalized (to the extent they are properly allocable to property acquired for resale) include spoilage, which is defined as including costs of rework labor, scrap, and spoilage.

Based on the facts provided, we must determine whether the cost of defective merchandise is rework labor, scrap or spoilage capitalizable to the non-defective merchandise as indirect costs pursuant to § 1.263A-1(e)(3)(ii)(Q), or instead whether the defective merchandise qualifies as subnormal goods that may be accounted for under § 1.471-2(c).¹

Rework labor, scrap, and spoilage are examples of indirect costs that must be capitalized to the extent they are properly allocable to property produced or property

¹ To the extent the LIFO method is used for a particular class of goods, however, any subnormal goods within that class may not be valued at less than their original cost. Rev. Rul. 76-282, 1976-2 C.B. 137.

acquired for resale. Although these terms are not defined in the regulations, they are generally defined in cost accounting literature. See e.g. Charles T. Horngren et. al., Cost Accounting, A Managerial Emphasis 625--652 (Prentice Hall 11th ed. 2003). The cost accounting definitions of the terms all reference a production process. For example, “rework” is defined as *production* that initially does not meet certain standards and is subsequently reworked and sold as acceptable finished units. Id. at 626. Detection of the defect may occur during or after production, but before units are shipped to customers. Id. Computers that do not meet certain standards prior to their shipment to customers, and that are reworked and sold as first quality products, are examples of rework. “Scrap” is defined as material that is left over from the *making of a product* and that has a relatively minor recovery value as compared to the value of the product. Id. For example, a hardwood floor manufacturer may grind leftover lumber into sawdust for sale as scrap, at a nominal price, to third parties. Finally, “spoilage” is defined as *production* that does not meet certain standards and that is discarded or sold for reduced prices. Id. Spoilage includes defective clothing that is sold as “irregular” for a reduced price.

Prior to the enactment of § 263A, a manufacturer was required to capitalize the cost of rework labor, scrap and spoilage to the cost of inventory only if it did so for financial accounting purposes. See § 1.471-11(c)(2)(iii)(d). But even manufacturers that capitalized the cost of scrap and spoilage for tax and financial accounting purposes were eligible to apply the rules of § 1.471-2(c) to qualifying merchandise.² Thus, even before the enactment of § 263A, the regulations contemplated a distinction between scrap and spoilage on the one hand and subnormal goods on the other. Although the precise line between those two categories in the context of a manufacturer may not be clear, we believe that first quality manufactured goods that become unsalable at normal prices or unusable in the normal way for the reasons described in § 1.471-2(c) after the production process is complete would qualify for valuation at net realizable value pursuant to § 1.471-2(c). Such goods would not meet the definition of scrap or spoilage because they are neither materials left over from a production process nor finished goods that fail to meet applicable quality standards.

Resellers, in contrast, were not required to capitalize scrap or spoilage costs prior to the enactment of § 263A. See § 1.471-3(c). A reseller was required only to capitalize the cost of merchandise and related transportation charges. Id. Defective goods in the hands of a reseller, generally, would qualify as subnormal goods under § 1.471-2(c) and could be written down to their net realizable value pursuant to that section.

We must determine whether § 263A and the regulations thereunder, and particularly § 1.263A-1(e)(3)(ii)(Q), require a reseller, that could write down the cost of defective goods (in whole or in part) under prior law, to capitalize the cost of defective goods as an indirect cost (i.e., scrap or spoilage) of other non-defective goods.

² Rework labor is not discussed here because the merchandise at issue is not reworked and sold as first quality units.

As explained above, the terms “rework labor,” “scrap,” and “spoilage” are defined in cost accounting literature by reference to a production process. To analyze whether those costs are properly capitalizable to merchandise acquired for resale, we first need to consider how those definitions might apply in a resale context. The concept of “rework labor” does not fit the typical reseller business model very well. It would be unusual for a reseller to engage in activities that are in the nature of “rework labor.” Likewise, resellers that are not engaged in some type of production activity generally would not have any materials left over from a production process that would be in the nature of scrap as defined in cost accounting literature. On the other hand, to the extent a reseller purchased merchandise with a manufacturing defect (i.e. the defect arose from the vendor’s production process), this merchandise could be considered spoilage because the merchandise is either discarded or sold at reduced prices by the reseller.

As noted above with respect to manufacturers, the requirement to capitalize spoilage does not completely eliminate the ability of a taxpayer to make use of the subnormal goods rules of § 1.471-2(c). As in the case of a manufacturer, we believe that first quality merchandise that becomes unsalable at normal prices or unusable in the normal way after acquisition by a reseller would qualify as subnormal goods that could be accounted for under § 1.471-2(c). Thus, the issue we must decide here is whether goods that were defective at the time of purchase qualify as subnormal goods eligible for valuation under § 1.471-2(c).

In the case of a reseller, the line between “spoilage” and “subnormal goods” could be drawn based on when the goods became defective, damaged, etc. If the goods were defective or damaged at or before acquisition, they would qualify as spoilage and if they were damaged after acquisition, they would qualify as subnormal goods. In practice, however, this distinction would often be difficult to administer. Moreover, to the extent the reseller is able to return defective merchandise for a refund, the issue would be moot.

Although we recognize that the term “spoilage” could be fitted to the resale context, we do not believe that § 1.263A-1(e)(3)(ii)(Q) was intended to change the traditional cost accounting definition of the term. Nor do we believe that it was intended to limit a reseller’s ability to apply the rules of § 1.471-2(c) to qualifying goods. We believe that § 1.263A-1(e)(3)(ii)(Q) was intended to require manufacturers to capitalize rework labor, scrap and spoilage even if they did not capitalize those costs for financial accounting purposes. Therefore, we conclude that resellers are not required to capitalize the acquisition cost of defective merchandise as an indirect cost of non-defective merchandise under § 1.263A-1(e)(3)(ii)(Q).

Please call (202) 622-4970 if you have any further questions.